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Ref: EFRAG's due process on the IASB's Exposure Draft Provisions – Targeted Improvements

Dear Dr Klinz,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to respond to the EFRAG's due process with regards to Exposure Draft ED/2024/8 Provisions – Targeted Improvements. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS.

Similarly to EFRAG, ESMA supports the IASB's efforts to resolve a number of the application issues that arise when recognising a provision. ESMA generally supports (or does not object to) the IASB's proposals and agrees that several of the proposals may reduce the diversity in practice related to the application of some IAS 37 requirements and provide more useful information to users of financial statements. However, we would recommend providing some additional guidance and examples.

While ESMA acknowledges that the targeted improvements, in some cases, would lead to an earlier recognition of provisions, it also considers that this would allow for better alignment between the recognition of revenues and associated expenses which would result in these being more faithfully represented. ESMA also notes that the proposed amendments may require more judgement and increase uncertainty when making estimates compared to the current requirements. However, such judgements and uncertainties are inherent in the preparation of estimates and do not undermine the accuracy or usefulness of such estimates in preparing financial information, if they are appropriately described in the notes to the financial statements.

ESMA's detailed responses are included in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit (Isabelle.Grauer-Gaynor@esma.europa.eu).

Yours sincerely,

[Verena Ross]

Appendix

1 Present obligation recognition criterion

Question 1 – Present obligation recognition criterion

The IASB proposes:

- a) to update the definition of a liability in IAS 37 Provisions, Contingent Liabilities and Contingent Assets to align it with the definition in the Conceptual Framework for Financial Reporting (paragraph 10);
- b) to align the wording of the recognition criterion that applies that definition (the present obligation recognition criterion) with the updated definition of a liability (paragraph 14(a));
- c) to amend the requirements for applying that criterion (paragraphs 14A–16 and 72–81); and
- d) to make minor amendments to other paragraphs in IAS 37 that include words or phrases from the updated definition of a liability (Appendix A).

The proposals include withdrawing IFRIC 6 Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment and IFRIC 21 Levies (paragraph 108).

Paragraphs BC3–BC54 and BC86 of the Basis for Conclusions and Appendix A to the Basis for Conclusions explain the IASB’s reasoning for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, which aspects do you disagree with and what would you suggest instead?

1. ESMA supports the alignment of the liability definition in IAS 37 and of the wording of the recognition criterion that applies that definition with the definition in the Conceptual Framework for Financial Reporting as well as better distinguishing between the two conditions for a present obligation: the obligation condition and the past-event condition.
2. ESMA notes that in the new paragraph 14F(a), the IASB proposes to replace the requirement that a legal obligation can be ‘enforced by law’ with a more detailed description of circumstances in which an entity would have no practical ability to avoid discharging a legal obligation. In particular, based on concepts in paragraph 4.34 of the Conceptual Framework, this includes a specific requirement that the economic consequences for the entity of not discharging its responsibility are expected to be significantly worse than the costs of discharging it. ESMA considers it important to explain in the Basis for Conclusion why similar wording which can be understood as the ‘economic compulsion’ is not also included in paragraph 14F(b), which addresses the case of a constructive obligation (e.g. the existence of valid expectations by other parties that the entity will discharge the responsibility, implies an expectation that the economic consequences of not discharging the responsibility are significantly worse than the costs of discharging it). Having said that,

ESMA questions the added value of repeating in paragraph 14F(b) the definition of a constructive obligation (which is included in paragraph 10).

3. ESMA does not object to the proposed withdrawal of IFRIC 21 and to the addition of specific requirements for situations in which the obligation to transfer an economic resource is subject to taking two (or more) separate actions, as well as for the treatment of threshold-triggered costs. ESMA notes that, as a result of these amendments, some provisions (e.g. provisions related to some levies imposed by a government on an entity) would be recognised earlier in practice than under the current requirements of IAS 37. ESMA agrees that starting to accrue the provision before exceeding the threshold would provide useful information when a transfer of economic resources to settle the obligation is probable and a reliable estimate can be made. The same applies when, in situations in which the obligation to transfer an economic resource is subject to taking two (or more) separate actions, an entity has taken the first action (or any of the actions) and if it has no practical ability to avoid the remaining actions. Due to the conceptual novelty of these specific requirements and the resulting expected changes in the accounting treatment of some levies, ESMA recommends that the IASB ensures that new requirements will not result in unintended consequences and carefully analyses the effect of the amendments on the various fact patterns that exist in practice.¹
4. ESMA acknowledges that the term ‘taking action’ proposed by the IASB in paragraph 14D of the ED is broader than most common definitions and also encompasses – in colloquial language – passive states, such as owning of a certain asset. There may be taxes or levies related to an entity’s passive status, such as an entity’s legal form or formal ownership of a specific license. Preparers and enforcers may be uncertain as to whether obligations based on such passive status would trigger the recognition of provisions under IAS 37. The requirement would be clearer if this were made explicit in paragraph 14D, for example by adding ‘owning a specific license’ to the list of circumstances understood to constitute taking action.
5. ESMA considers that application of the proposed requirements may lead to more frequent application of judgement by entities and that more uncertainty may be attached to the preparation of estimates. This applies in particular to the assessment of (i) whether it is probable that a threshold will be exceeded, (ii) whether there are two separate actions or only one single action, or (iii) whether there is a practical ability to avoid taking the second (last) action. However, ESMA also notes that, according to paragraph 2.19 of the Conceptual Framework for Financial Reporting, the use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Consequently, ESMA expects that the proposals will lead to more relevant

¹ For instance, it would be useful to make it clear in Example 13B of the Guidance on implementing IAS 37 that even when the entity has no practical ability, at the end of a reporting period, to avoid payment of the levies resulting from operating as a bank in subsequent periods, no provisions should be recognised to account for the levies of future years. This is because no actions required for these levies to be payable (the bank operating) have been (yet) taken by the entity at the end of the current reporting period.

information for users and is of the view that the IASB strikes the right balance between relevance and faithful representation.

6. Having said that, ESMA encourages the IASB to provide additional guidance and/or examples, in particular on how to determine whether an entity has a practical ability to avoid future actions. Moreover, ESMA notes that there could be difficulties in identifying relevant actions for some recurring property-based taxes. This could be the case, for example, for a tax that must be paid by an entity operating at the beginning of the accounting period X and that is calculated by applying the rates effective at the end of period X-1 to the value of the assets owned or leased by this entity at the end of period X-2 (provided that there is no practical ability at the end of period X-1 to avoid payment of the tax at the beginning of period X).
7. While ESMA supports the inclusion of the example illustrating the application of the requirements for threshold-triggered costs (paragraph 14P of the ED), more specific details including the calculation of provisions based on the specific figures, could make this example even easier to understand. It could also be useful to state clearly (as in paragraph BC41 of Basis for Conclusions) that the total activity on which the amount of the transfer of an economic resource includes both activity below the threshold and activity above the threshold.
8. Furthermore, ESMA notes that the proposed new paragraph 14G (similarly to existing paragraph 22) requires that, if details of a proposed new law have yet to be finalised, an obligation arises when the legislation is virtually certain to be enacted as drafted. ESMA considers that it could be useful to explain in the Basis for Conclusion whether the criterion “virtually certain to be enacted as drafted” is identical with the criterion “enacted or substantively enacted” used in paragraph 46 of IAS 12 *Income Taxes*.

2 Measurement—Expenditure required to settle an obligation

Question 2 – Measurement—Expenditure required to settle an obligation

The IASB proposes to specify the costs an entity includes in estimating the future expenditure required to settle an obligation (paragraph 40A).

Paragraphs BC63–BC66 of the Basis for Conclusions explain the IASB’s reasoning for this proposal.

Do you agree with this proposal? Why or why not? If you disagree, what would you suggest instead?

9. ESMA supports the proposed clarification of which costs should be considered as expenditures required to settle an obligation. ESMA notes that the requirement is consistent with the requirement in paragraph 68A which specifies the cost used to determine whether a contract is onerous.

10. However, ESMA notes that paragraph 37 of IAS 37 remains unchanged and refers to two bases for measuring a provision: either a settlement cost, as defined in draft paragraph 40A, or a transfer cost. ESMA suggests that the IASB clarifies the relationship between paragraph 37 and the proposed new paragraph 40A.
11. ESMA would find it useful if the IASB provided additional guidance and/or examples illustrating the types of costs that are directly related to settling obligations. For example, diversity appears to exist as to whether an entity's legal fees in a lawsuit should be included in a provision. In addition, the IASB could consider requiring disclosure of the material cost components included in estimating future expenditures as it may be useful to users.

3 Discount rates

Question 3 – Discount rates

The IASB proposes to specify that an entity discounts the future expenditure required to settle an obligation at a rate (or rates) that reflect(s) the time value of money — represented by a risk-free rate—with no adjustment for non-performance risk (paragraphs 47–47A).

The IASB also proposes to require an entity to disclose the discount rate (or rates) it has used and the approach it has used to determine that rate (or those rates) (paragraph 85(d)).

Paragraphs BC67–BC85 of the Basis for Conclusions and Appendix B to the Basis for Conclusions explain the IASB's reasoning for these proposals.

Do you agree with:

- a) the proposed discount rate requirements; and
- b) the proposed disclosure requirements?

Why or why not? If you disagree, what would you suggest instead?

12. ESMA agrees with the IASB's proposal to provide clarifications on how the discount rate used to determine the amount of a provision is determined. In particular, ESMA supports the proposals that (i) the time value of money reflected by this discount rate should be represented by a risk-free rate and that (ii) the discount rate should not reflect the risk that that the entity will not settle the liability (non-performance risk).
13. ESMA notes that IFRS 13 requires entities to consider non-performance risk when measuring the fair value of liabilities. However, ESMA agrees with the IASB that disregarding this risk when determining the amount of a provision would reflect an important difference between provisions within the scope of IAS 37 and liabilities that arise from exchange transactions: the latter (contrary to the former) typically include an obligation for an entity to pay the counterparty a compensation for accepting non-performance risk. Moreover, this proposal would also ensure better comparability, as the measurement approaches regarding the non-performance risk may significantly vary between entities.

14. ESMA would generally see it useful if the IASB was to provide additional guidance to achieve a more uniform approach to the estimation of the risk-free interest rate by entities. It would also be preferable to have a consistent approach in determining the discount rates used in the measurement of provisions across IFRS Accounting Standards (ESMA notes that IAS 19 *Employee Benefits* does not require the use of a risk-free interest rate). Such a consistent approach including additional guidance on estimating the risk-free interest rate could be developed in future IASB projects.
15. ESMA supports the IASB's proposal to disclose for each class of provision (i) the discount rate(s) used and (ii) the approach applied to determine the rate(s) used.

4 Transition requirements and effective date

Question 4 – Transition requirements and effective date

4(a) Transition requirements

The IASB proposes transition requirements for the proposed amendments (paragraphs 94B–94E).

Paragraphs BC87–BC100 of the Basis for Conclusions explain the IASB's reasoning for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, which aspects do you disagree with and what would you suggest instead?

4(b) Effective date

If the IASB decides to amend IAS 37, it will decide on an effective date for the amendments that gives those applying IAS 37 sufficient time to prepare for the new requirements.

Do you wish to highlight any factors the IASB should consider in assessing the time needed to prepare for the amendments proposed in this exposure draft?

16. ESMA agrees with the transition requirements proposed by the IASB.

5 Disclosure requirements for subsidiaries without public accountability

Question 5 – Disclosure requirements for subsidiaries without public accountability

The IASB proposes to add to IFRS 19 *Subsidiaries without Public Accountability: Disclosures* a requirement to disclose the discount rate (or rates) used in measuring a provision, but not to add a requirement to disclose the approach used to determine that rate (or those rates) (Appendix B).

Paragraphs BC101–BC105 of the Basis for Conclusions explain the IASB's reasoning for this proposal.

Do you agree with this proposal? Why or why not? If you disagree, which proposal do you disagree with and what would you suggest instead?

17. ESMA has no comments on this question.

6 Guidance on implementing IAS 37

Question 6 – Guidance on implementing IAS 37

The IASB proposes amendments to the Guidance on implementing IAS 37 Provisions, Contingent Liabilities and Contingent Assets. It proposes:

- a) to expand the decision tree in Section B;
- b) to update the analysis in the illustrative examples in Section C; and
- c) to add illustrative examples to Section C.

Paragraphs BC55–BC62 of the Basis for Conclusions explain the IASB’s reasoning for these proposals.

Do you think the proposed decision tree and examples are helpful in illustrating the application of the requirements? If not, why not?

Do you have any other comments on the proposed decision tree or illustrative examples?

18. ESMA finds the proposed expansion of the decision tree useful. It also supports the updated existing illustrative examples and proposed new examples.

19. As already mentioned in ESMA’s comment letter on the IASB’s Exposure Draft Climate-related and Other Uncertainties in the Financial Statements², ESMA also encourages the IASB to consider including an example connected to net zero commitments linked to the IFRS IC’s April 2024 agenda decision (AD)³. The example could either (i) not lead to the recognition of a provision as further elaborated in the AD, but information would be disclosed in accordance with paragraph 31 of IAS 1 to connect the information included in the sustainability section regarding net zero commitments and the non-recognition of provisions or (ii) lead to the recognition of a provision, building on fact patterns where the recognition of a provision would be necessary (e.g. a present obligation resulting from past emissions) vis-a-vis the climate commitments disclosed by the entity.

7 Other comments

Question 7 – Other comments

² [ESMA32-483087481-78 Letter to IASB on the Exposure Draft Climate-related and Other Uncertainties in the Financial Statements \(proposed illustrative examples\)](#)

³ [Climate-related Commitments \(IAS 37 Provisions, Contingent Liabilities and Contingent Assets\)](#)

Do you have comments on any other aspects of the proposals in the Exposure Draft?

20. ESMA notes that although paragraph 165 of IAS 19 contains a requirement on the recognition date of termination benefits, as well as a cross-reference to the requirements of IAS 37 on restructuring, IAS 37 does not contain any cross-reference to IAS 19. ESMA, therefore, suggests adding a cross-reference to paragraph 165 of IAS 19 in the new paragraph 80A. In addition, we suggest that the IASB considers the harmonising of principles on the recognition of termination benefits in IAS 19 and IAS 37, as the two standards differ in terms of when a liability should be recognised (for example, depending on the fact pattern, a provision for a restructuring plan consisting solely of termination benefits could be recognised at different times depending on whether the restructuring plan is analysed under IAS 19 or IAS 37)
21. Finally, ESMA notes that the consistency of the wording in the ED could be improved. For example, the ED uses the term “probable” in some cases, “more likely than not” in other cases, and sometimes also “probable (more likely than not)”.